

**Financial Review of Criminal Investigation's
Group I Undercover Operations**

September 2001

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

2d = Law Enforcement Technique(s)



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 24, 2001

MEMORANDUM FOR CHIEF, CRIMINAL INVESTIGATION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Financial Review of Criminal Investigation's
Group I Undercover Operations

This report presents the results of our financial review of Criminal Investigation's (CI) Group I undercover operations. The objective of the review was to determine whether the financial records fairly presented the results of the operation.

In summary, we found that the financial records for 16 of the 17 Group I undercover operations fairly presented the revenue and expenses of the operations. However, in one instance, we were unable to attest to whether the financial records fairly presented the revenues and expenses of the operation because of inconsistent accounting practices. Additionally, the Internal Revenue Service (IRS) has inconsistently treated income earned from undercover operations with churning authority, and did not accurately report the expenses of the operations with churning authority to the Congress.

We believe that CI management should issue guidance regarding the handling of income and expenses for churning purposes and reporting expenditures to the Congress. CI management should ensure that the guidance issued promotes accuracy, uniformity, and consistency in accounting for undercover operations.

In commenting on a draft of this report, CI management concurred with our findings and agreed to take corrective actions on our recommendations. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or John R. Wright, Acting Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 927-7077.

**Financial Review of Criminal Investigation's
Group I Undercover Operations**

Table of Contents

Executive Summary	Page i
Objective and Scope	Page 1
Background	Page 2
Results.....	Page 3
The Internal Revenue Service Is Not Consistently Treating Income Earned from Undercover Operations	Page 3
Expenditures of Undercover Operations Were Not Accurately Reported to the Congress	Page 6
Some Improvements Are Needed in the Accounting Practices for Undercover Operations.....	Page 8
Conclusion.....	Page 13
Appendix I – Detailed Objective, Scope, and Methodology.....	Page 15
Appendix II – Major Contributors to This Report.....	Page 17
Appendix III – Report Distribution List.....	Page 18
Appendix IV – Outcome Measures.....	Page 19
Appendix V – Management’s Response to the Draft Report.....	Page 21

Financial Review of Criminal Investigation's Group I Undercover Operations

Executive Summary

In support of the overall Internal Revenue Service (IRS) mission, the Criminal Investigation function (hereafter referred to as CI) is responsible for investigating potential criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the tax laws. CI Group I operations include the most sensitive undercover operations conducted, are expected to last longer than 6 months, and have anticipated costs in excess of \$20,000.

Group I operations can involve setting up various business activities as a cover to assist in obtaining evidence of illegal actions. The IRS has the authority to use proceeds from the cover business to offset the expenses of the undercover operation. Using income earned during an operation to offset expenses is referred to as churning.

Because of concerns expressed by the Senate Finance Committee staff and the IRS CI management, we performed a financial review of closed IRS CI Group I undercover operations, including operations that were authorized to use the churning authority. Our overall objective was to determine whether the financial records fairly present the results of the operation.

Results

The financial records for 16 of the 17 Group I undercover operations that we reviewed fairly present the revenue and expenses of the operations. In one instance, we were unable to attest to whether or not the financial records fairly presented the revenues and expenses of the operation because of inconsistent accounting practices.

Additionally, the IRS has not maximized the benefits from its churning authority and, inadvertently, did not accurately report the expenses of the operations with churning authority to the Congress. We also noted that accounting practices could be improved to adequately safeguard IRS resources.

The Internal Revenue Service Is Not Consistently Treating Income Earned from Undercover Operations

The IRS has churning authority, which allows the income earned from undercover operations to be used to offset the expenses of the operation. However, undercover operations with churning authority were not consistently treating earned income to offset expenditures of the operation. Five of the 17 Group I undercover operations we reviewed were authorized to churn funds. Four of these five operations earned sufficient income to

Financial Review of Criminal Investigation's Group I Undercover Operations

attempt to use the churning authority. However, in all four instances, the IRS did not consistently use its churning authority to offset expenses.

In December 1997, the Chief, CI, issued a memorandum stating that income earned could not be used to pay expenses of the undercover operation directly. According to the Director, Special Investigative Techniques Section, the offsetting of expenses was cumbersome for the agents, and it was decided that the income, up to the amount of confidential funds authorized, would be remitted to the IRS Finance Division.

We believe that the use of consistent accounting methods enhances the reliability of the information presented. The Chief, CI, needs to provide for the consistent treatment of income earned during undercover operations to ensure that it is properly used to offset the expenses of the operation.

Expenditures of Undercover Operations Were Not Accurately Reported to the Congress

CI inadvertently did not accurately report to the Congress financial information on undercover operations that were authorized to churn. We analyzed the expenditures reported to the Congress in Fiscal Year (FY) 1999 and FY 1998 for the five operations included in our review that were authorized to churn. Each operation used different time periods to capture the expenditures reported to the Congress in the FY 1998 and 1999 reports. As a result, these annual reports to the Congress do not provide a reliable means for determining the total expenditures of an operation. For instance, in FY 98, CI reported to the Congress that a total of \$812,000 was expended for undercover operations that it was authorized to churn, and CI reported that a total of \$1.44 million was expended in FY 99. In contrast, we calculated the expenditures from the inception for these operations at \$931,000 in FY 1998 and \$1.46 million in FY 1999. Accordingly, we believe CI needs to ensure that all operations use the same time periods when calculating the expenditures reported to the Congress to provide an accurate portrayal of income and expenses of the operations.

Some Improvements Are Needed in the Accounting Practices for Undercover Operations

Accounting practices at various locations need improvement to adequately safeguard IRS resources. We determined that income and expenses were not properly reported, recoverable funds were commingled with confidential funds, and documentation was insufficient to properly account for expenses. Further, we could not attest to the revenue and expenses in the operation 2d-----due to inconsistent accounting practices.

Financial Review of Criminal Investigation's Group I Undercover Operations

Summary of Recommendations

The Chief, CI, should issue guidance regarding the handling of income and expenses for churning purposes and reporting expenditures of applicable operations to the Congress and ensure that guidance issued to account for funds used in undercover operations promotes accuracy, uniformity, and consistency in accounting for undercover operations.

Management's Response: CI management agreed that some clarification and consistency is needed on the financial aspects of their undercover operations and has already addressed two issues raised in the draft report. CI management has changed the format used to request financial information from undercover operations that are authorized to churn and has mandated the use of Quickbooks to account for funds for all undercover operations. CI management will also issue guidance for the treatment of churned income. Management's complete response to the draft report is included as Appendix V.

Financial Review of Criminal Investigation's Group I Undercover Operations

Objective and Scope

The overall objective of this review was to determine whether the financial records fairly present the results of the operation.

The overall objective of this review was to determine whether the financial records fairly present the results of the operation. Our review also evaluated whether adequate controls were established to ensure compliance with laws and regulations that have a material impact on the financial aspects of the operation.

Because of concerns expressed by the Senate Finance Committee staff and the Internal Revenue Service (IRS) Criminal Investigation (hereafter referred to as CI) management, we performed a financial review of closed IRS CI Group I undercover operations, including operations that were authorized to use the churning authority. The IRS CI management requested the audit to fulfill the intent of a prior corrective action to a General Accounting Office (GAO) report¹ requiring that financial reviews be conducted by the former Inspection Service's Internal Audit function (now the Treasury Inspector General for Tax Administration's Office of Audit).

The audit work was performed from August 2000 to April 2001 at IRS CI offices in 2d-----

2d-----

2d----- This audit was performed in accordance with *Government Auditing Standards*. The review was limited in scope and focused on the financial records and related internal controls for the specific undercover operations. We did not perform substantive testing on the veracity of the expenditures being made by the operations.

¹ GAO report (GGD-9279, dated April 1992).

Financial Review of Criminal Investigation's Group I Undercover Operations

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

In support of the overall IRS mission, CI is responsible for investigating potential criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the tax laws.

CI uses different investigative techniques to help fight financial crimes related to tax administration. An undercover operation is a law enforcement technique whereby an agent acting under an assumed identity is placed inside the suspected criminal enterprise. The primary purpose in using this technique is to detect and expose the criminal activity by acquiring relevant evidence for criminal prosecution. CI uses undercover operations during investigations of illegal activities such as narcotics trafficking, money laundering, fraudulent tax preparation, tax refund fraud, and the skimming of business profits.

CI undercover operations are classified as either Group I or Group II operations.² Group I operations include the most sensitive undercover operations conducted, are expected to last longer than 6 months, and have anticipated costs in excess of \$20,000. Additionally, some undercover operations that meet one or more specific sensitive criteria as outlined in the Internal Revenue Manual (IRM), such as possible corrupt action by a public official or a significant risk of violence to individuals, are classified as Group I operations regardless of expected duration or cost.

² Group II operations are all undercover operations that do not meet the criteria for Group I operations.

Financial Review of Criminal Investigation's Group I Undercover Operations

Using income earned during an operation to offset expenses is referred to as churning.

Group I operations can involve setting up various business activities as a cover to assist in obtaining evidence of illegal actions. The IRS has the authority to use proceeds from the cover business to offset the expenses of the undercover operation. Using income earned during an operation to offset expenses is referred to as churning. The IRS is required to conduct detailed financial audits of undercover operations which were authorized to use this churning authority.

Results

The financial records for 16 of the 17 Group I undercover operations we reviewed fairly present the revenue and expenses of the operations. In one instance, we could not attest to whether the financial records fairly presented the revenues and expenses of the operation due to inconsistent accounting practices.

Additionally, the IRS has not consistently treated churned income from undercover operations and, inadvertently, did not accurately report the expenses of the operations with churning authority to the Congress. Also, we noted deficiencies with accounting practices at various locations. However, these deficiencies did not materially affect the accountability over revenues and expenses of the operations.

The Internal Revenue Service Is Not Consistently Treating Income Earned from Undercover Operations.

The IRS has churning authority, which allows the income earned from undercover operations to be used to offset the expenses of the operation. However, undercover operations with churning authority were not consistently treating earned income to offset expenditures of the operation. Five of the 17 Group I undercover operations examined during this review were authorized to churn funds. Four of these five operations

Financial Review of Criminal Investigation's Group I Undercover Operations

The IRM requires operational expenses to be paid from earned income before confidential funds are expended.

earned sufficient income to attempt to use the churning authority. In all four instances, the IRS was inconsistent on how it applied its churning authority.

The Anti-Drug Abuse Act of 1988³ exempted IRS undercover operations from the otherwise applicable statutory restrictions controlling the use of Government ends (which generally provides that all receipts be deposited in the General Fund of the Treasury and all expenses paid out of appropriated funds). This exemption originally expired on December 31, 1989, but was extended to December 31, 1991. On June 30, 1996, the Taxpayer Bill of Rights 2⁴ reinstated the IRS' churning authority until January 1, 2001. The Congress recently passed the Consolidated Appropriations Act, 2001, which extends the IRS' churning authority until January 1, 2006.⁵

The IRS issued guidance to contact agents⁶ on churning income through the IRM and memoranda. When an operation has churning authority, the IRM requires the expenses from the operation to first be paid from the income earned during the operation. Once the income earned from the operation is used, confidential funds are to be used to continue to pay expenses for the operation.

The income earned by the operation is to be maintained in a separate bank account by the contact agent. On a monthly basis, a Claim for Reimbursement for Expenditures on Official Business (Standard Form 1164) is to be used to account for the imprest funds and the churned funds separately. Any income

³ Anti-Drug Abuse Act of 1988, 26 U.S.C. § 7608(c).

⁴ Taxpayer Bill of Rights 2 (TBOR2), Pub. L. No. 104-168, 110 Stat. 1452 (1996) (codified as amended in scattered sections of 26 U.S.C.).

⁵ Consolidated Appropriations Act, 2001 (App. I § 303), 26 U.S.C. § 7608(c)(6).

⁶ Agent assigned to perform on-site liaison with the undercover agent and to be primarily responsible for the security of the undercover agent. Now called cover agent.

Financial Review of Criminal Investigation's Group I Undercover Operations

remaining at the end of the operation is to be forwarded to the General Fund. In our opinion, these procedures generally comply with the intent of the churning legislation.

However, the Director, Special Investigative Techniques Section, stated that the offsetting of expenses was cumbersome for the agents; therefore, the Chief, CI, issued a memorandum on December 15, 1997, outlining alternative procedures for churning funds. The alternative procedures provided that the income earned from undercover operations could not be used to pay the expenses of the undercover operations directly. The memorandum directed that the income, up to the amount of confidential funds authorized, must be remitted to the IRS Finance Division. Any income in excess of the undercover operation's expenses was to be remitted to the IRS Regional Commissioner for deposit into the General Fund.

The conflicting procedures caused the income earned during the undercover operations to be treated differently. For instance, one operation never used the \$4,900 income earned to pay expenses incurred in the undercover operation and still had the income in a bank account after the operation was closed in November 1998. In the other three operations, the income was used for various periods of time to pay expenses incurred during the undercover operations. These 3 operations had earned income of \$16,300, \$264,000, and \$19,200, respectively.

Each operation authorized for churning treated income earned differently.

One of these three operations initially used the income earned to pay expenses of the undercover operation, but subsequently reimbursed the income account and held the income until the operation closed. Another undercover operation used the income to pay undercover expenses for 9 months, then discontinued this procedure in August 1997 and accumulated the income in a bank account. At the close of these two operations, the income earned was remitted to the IRS with a request to apply the monies to the undercover operation expenses.

Financial Review of Criminal Investigation's Group I Undercover Operations

The Chief, CI, needs to provide for the consistent treatment of income earned during undercover operations.

In the third undercover operation, the income earned was not used to pay expenses for the first 6 months of the operation. However, from September 1999 to March 2000, the income earned was used to offset losses incurred by the undercover operation.

Sound business practices support the use of consistent accounting methods to enhance the reliability of the information presented. The Chief, CI, needs to provide for the consistent treatment of income earned during undercover operations to ensure that it is properly used to offset the expenses of the operation.

Recommendation

1. The Chief, CI, should issue guidance that clarifies the accounting practices that should be followed for undercover operations approved for churning to ensure income from an operation is properly used to offset the expenses of that operation.

Management's Response: CI management will reissue the memorandum on the alternative treatment of churning that was previously issued on December 15, 1997, and will provide additional guidance on the treatment of churning in gambling undercover operations.

Expenditures of Undercover Operations Were Not Accurately Reported to the Congress

CI is not accurately reporting to the Congress financial information on undercover operations that were authorized to churn, but was unaware of the inaccuracies. We reviewed two financial reports provided to the Congress and determined that the time periods used to capture the expenditures reported were inconsistent among operations. As a result, these annual reports to the Congress do not provide a reliable means for determining the total expenditures of an operation.

The TBOR2, which reinstated the IRS's churning authority, amended the reporting requirement to include

Financial Review of Criminal Investigation's Group I Undercover Operations

Expenditures of undercover operations were inaccurately reported to the Congress.

the date the operation was initiated, the date offsetting was approved, the total current expenditures and the amount and use of proceeds of the operation, a detailed description of the undercover operation projected to generate proceeds, and results of the operation to date.

We analyzed the expenditures reported to the Congress in Fiscal Year (FY) 1999 and FY 1998 for the five operations included in our review that were authorized to churn. For FY 1999, we noted that the operations used different time periods to calculate the expenditures reported to the Congress. For instance, one operation reported only FY 1999 expenses, one reported more expenses than were actually incurred for the entire operation, one reported expenses through FY 1998, and another operation reported expenses from inception through FY 1999. As a result of these various reporting practices, the reports to the Congress reflected that a total of \$1.44 million was expended for operations that churned in FY 1999. However, we calculated the expenditures from the inception for these operations at \$1.46 million.

Expenditures for the undercover operations reported to the Congress for FY 1998 also reflected inconsistencies in the time periods used for reporting. For two of the operations, we could not determine what period of time was used to calculate the amount of expenditures reported. Another operation included expenses through August 1998, and the fourth operation reported expenses through FY 1997. CI reported to the Congress that a total of \$812,000 was expended for undercover operations that it was authorized to churn in FY 1998. However, we calculated that these operations expended \$931,000.

According to the CI senior analyst who prepared the reports to the Congress, the field office for each operation prepared the information contained in the report, and no guidance had been provided on the period of time to be used in calculating the total current expenditures.

Financial Review of Criminal Investigation's Group I Undercover Operations

CI needs to be consistent in calculating the expenditures reported to the Congress to provide an accurate portrayal of income and expenses of its undercover operations. Without accurate reporting of undercover operation expenditures, it is difficult to measure the level of resources being used by the operation and to determine compliance with the legislative and IRS procedural requirements.

Recommendation

2. The Chief, CI, should provide guidance to field operations regarding how to calculate the expenditure amounts that are used in the annual reports to the Congress.

Management's Response: The Special Investigative Techniques Section changed the format of the request to the field offices for FY 2000 figures regarding churning operations.

Some Improvements Are Needed in the Accounting Practices for Undercover Operations

Accounting practices at various CI locations need improvement to adequately safeguard IRS resources. We determined that income and expenses were not properly reported, recoverable funds⁷ were commingled with confidential funds,⁸ and documentation was insufficient to properly account for expenses. The following highlights, by location, the specific areas needing improvement.

Standards for Internal Control in the Federal Government provide as a control activity the accurate

⁷ Funds used in the undercover operation which are to be returned at the close of the operation.

⁸ Also referred to as nonrecoverable funds. Funds used to pay expenses of the undercover operation.

Financial Review of Criminal Investigation's Group I Undercover Operations

and timely recording of transactions and events. The accurate recording of income and expenses of an operation is critical in providing an accurate portrayal of the operation's resource commitment. Additionally, the IRM provides guidance on accounting for funds used in undercover operations.

2d-----

We could not attest to the revenue and expenses in the undercover operation identified as 2d-----

We could not attest to the revenue and expenses in the undercover operation identified as 2d-----due to inconsistent accounting practices. This operation was authorized to expend \$1,058,744 of confidential funds.

Financial entries were recorded in "Quicken" (an off-the-shelf single-entry accounting system software package), computerized spreadsheets, manual ledger cards, and handwritten worksheets. The recording of transactions in various financial records resulted in numerous discrepancies. In addition, expenses were netted against money laundering commissions.

This operation involved numerous authorized transactions where large sums of cash were laundered by either wiring monies to accounts specified by the targets or purchasing equipment. According to the pre-operational memorandum, "Quicken" was selected as the accounting system for this operation. However, all of the financial transactions were not recorded in "Quicken." For instance, instead of being deposited into a bank account, the undercover funds were taken directly to vendors and used to purchase equipment. These equipment purchases were recorded on a separate spreadsheet and not on the "Quicken" credit line ledger cards. These transactions totaled approximately \$300,000.

In addition, all invoices in the financial records could not be traced to either the "Quicken" credit line ledger cards or the handwritten worksheets used to record money laundering transactions. According to the contact agent, these invoices may have represented orders that were subsequently cancelled, since records documenting payment could not be located.

Financial Review of Criminal Investigation's Group I Undercover Operations

Also, the operation reported a loss of \$79,300 on the credit lines; however, the supporting ledgers totaled approximately \$56,500. According to the contact agent, he changed the method of recording transactions for two credit lines. This change resulted in an erroneous balance of \$56,500 being reflected in the supporting ledgers. By reviewing the individual transactions, we confirmed that the balance should have been reflected as \$79,300 in the supporting ledgers.

Further, according to financial records, the operation reported approximately \$2,400 and \$1,800 profit on the credit lines and equipment purchases, respectively. The operation also reported \$79,300 and \$18,600 in losses for the credit lines and equipment purchase transactions. However, the accounting practices used by the contact agent did not contain sufficient detail to confirm the calculation of these profits and losses.

IRM 9.4.8.17 states, "The requisite financial records for an undercover operation business operation will be addressed at the pre-operational meeting. In all instances, the records should be sufficient to reflect all receipts and disbursements of the business. The nature of the business should dictate the complexity of the books and records. The undercover agent or contact agent should establish a business bank account that will remain separate from all other undercover accounts. Generally, all receipts for sales or services should be deposited into the business account."

Additionally, we noted that commissions earned on money laundering activities were not properly reported. We could not readily establish what the total commissions earned were since in some instances the contact agent recorded a set commission and in other instances he subtracted expenses (e.g., bank charges, credit line payments, equipment purchases, etc.) from the commissions.

Although there was documentation to support the \$917,795 of total expenses reported for this operation, the lack of supporting documentation for some of the individual transactions, as described above, and

Financial Review of Criminal Investigation's Group I Undercover Operations

*Revenue and expenses were
not properly recorded.*

inconsistent accounting practices prevents us from rendering an opinion on the overall accuracy of the financial records.

2d-----

Income and expenses were not properly recorded for undercover operation 2d----- The operation involved undercover agents placing wagers on sporting events and was authorized to expend \$31,700 of confidential funds. The undercover agents attempted to place offsetting wagers so that the winning wagers would equal the losses of the losing wagers.

The Acting Director of National Operations issued guidance in October 1999 providing that, when the wagers offset, the operation would not reflect any income, but rather only the commissions charged on losing wagers and other non-wagering expenses would be reported as expenditures. We believe this practice does not accurately reflect the income and expenses of the operation. This issue was also identified in April 2000 when an operational review performed by CI cited the operation for not properly reporting the income earned by this operation.

By not following prudent reporting practices, the operation understated income and expenses by approximately \$15,400.

2d-----

In two operations, the income and expenses were not properly recorded. The expenses were netted against either interest income or a funding transfer that did not get recorded.

Operation 2d-----was transferred from one field office to another during the investigation. Expenses totaling approximately \$9,500 incurred by the recipient field office were netted against funding that was transferred by the initiating field office. This operation was authorized to expend \$404,913 of confidential funds. Also, undercover operation 2d-----netted bank charges of \$155 against interest earned over a

Financial Review of Criminal Investigation's Group I Undercover Operations

6-month period. This operation was authorized to expend \$25,000 of confidential funds.

The netting of expenses for both these operations caused the income and expenses of the operations to be understated.

2d-----

During undercover operation 2d----- which involved maintaining fictitious identities for undercover agents, confidential and recoverable funds were commingled in the undercover agents' identity bank accounts. This operation was authorized to expend \$290,925 of confidential funds.

Confidential and recoverable funds were commingled.

Each undercover agent established an identity bank account with confidential funds to maintain a history of financial transactions. Recoverable funds totaling \$50,000 were used to supplement the confidential funds. According to the IRM, confidential and recoverable funds should not be commingled. The IRM does allow recoverable funds to be transferred to a cover account on a temporary basis to assist in establishing a history of financial transactions, provided it is authorized by the Chief, CI.

The recoverable and confidential funds for this operation were commingled for over 6 years, and there was no authorization allowing the commingling of funds. However, according to the group manager, on a monthly basis each agent accounted for the recoverable and confidential funds in their account. The agents' managers and the Special Agent in Charge reviewed the agents' reconciliations. Although CI did take steps to oversee the account, the commingling of funds for an extended period of time increased the risk that recoverable funds were inappropriately spent on operational expenses.

Financial Review of Criminal Investigation's Group I Undercover Operations

An expenditure was paid twice, once with an original receipt and again with a photocopy.

2d-----

Undercover operation 2d-----was authorized to expend \$94,000 of confidential funds. An expenditure of approximately \$715 was paid twice, once with an original receipt and again with a photocopy.

The IRM provides that receipts for all items claimed as confidential expenditures should be obtained wherever possible. If an original receipt cannot be obtained and a photocopy is used, the undercover agent must include in the Daily Expense Sheet the reason why a receipt was not obtained.

In this instance, the photocopy did not stipulate why the original was not used. The payment of both the original and photocopy receipt may have allowed the undercover agent to be reimbursed \$715 more than was necessary. There was no evidence on file to account for this discrepancy, and we advised local CI management of this issue.

Recommendation

3. The Chief, CI, should ensure that guidance issued to account for funds used in undercover operations promotes accuracy, uniformity, and consistency in accounting for undercover operations.

Management's Response: In November 1997, CI mandated that field offices use Quickbooks on all undercover operations. Recently, CI retrained all undercover agents and required the use of Quickbooks. Using one software program should resolve accounting inconsistencies.

Conclusion

The Chief, CI, needs to provide for consistent treatment of income earned during undercover operations to ensure the income is properly used to offset expenses of the operation. In addition, CI needs to improve its accounting practices over Group I undercover operations

Financial Review of Criminal Investigation's Group I Undercover Operations

to ensure resources are adequately safeguarded. Finally, CI needs to ensure that the income and expenses for undercover operations are accurately captured so that the IRS and outside stakeholders can reasonably interpret the financial position of the operations.

Financial Review of Criminal Investigation's Group I Undercover Operations

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the financial records fairly present the results of the operation. To accomplish this objective, we:

- I. Determined if the internal controls over financial reporting for the undercover operation are adequate.
 - A. Obtained a list of Criminal Investigation function (hereafter referred to as CI) Group I undercover operations and judgmentally selected 17 of the 26 operations which were closed between February 1998 and April 2000.
 - B. Determined if the revenues and expenditures of the operation were properly accounted for and recorded.
 - 1. Reviewed Requests for Undercover Operation (Standard Form 8354) to determine the amount of recoverable and nonrecoverable funds requested.
 - 2. Reviewed fund ledgers, bank statements, receipts, and other records for the operation and scheduled financial activity.
 - 3. Determined whether the income from operations was commingled with the imprest fund advances or recoverable fund advances (i.e., separate bank account).
 - 4. Determined whether the income from the operation was returned to the General Fund at the conclusion of the operation.
 - 5. Reconciled the balance per the bank and the checkbook balance.
 - 6. Determined whether all applicable bank accounts had been closed and zeroed out at the conclusion of the operation.
 - 7. Determined whether income earned from undercover operations was used to offset the expenses of the operation.
 - C. Determined whether required financial reviews were conducted.
 - 1. Determined whether the Regional Undercover Program Manager conducted quarterly reviews of the operation.
 - 2. Determined if unannounced quarterly cash verifications of recoverable funds were performed.

**Financial Review of Criminal Investigation's
Group I Undercover Operations**

- II. Determined whether assets were properly safeguarded.
 - A. Determined whether all contact agent's checks were accounted for and numbered.
 - B. Determined whether the cash, checks, checkbook, ledgers, receipts, etc. were maintained in a locked box.
- III. Determined whether adequate controls were established to ensure compliance with laws and regulations that have a material impact on the financial aspect of the operation.
 - A. Reviewed the pre-operational minutes and memorandum with attachments for all relevant financial data, operational objectives, expected asset purchases, etc.
 - B. Reviewed the provisions under Internal Revenue Code § 7608(c), authority of internal revenue enforcement officers (rules relating to undercover operations),¹ and compared it to the pre-operational minutes.
 - C. Determined if the controls over the operation ensured compliance with the laws and regulations.

¹ Anti-Drug Abuse Act of 1988, 26 U.S.C.

**Financial Review of Criminal Investigation's
Group I Undercover Operations**

Appendix II

Major Contributors to This Report

Maurice S. Moody, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

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**Financial Review of Criminal Investigation's
Group I Undercover Operations**

Appendix III

Report Distribution List

Commissioner N:C
Deputy Chief, Criminal Investigation CI
Director, Operations and Policy Support CI:OPS
Director, Special Investigative Techniques Section CI:OPS
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaison: Criminal Investigation CI

Financial Review of Criminal Investigation's Group I Undercover Operations

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into the Treasury Inspector General for Tax Administration's (TIGTA) Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Actual: \$139,000 difference in expenditures between what TIGTA calculated and Criminal Investigation (CI) reported to the Congress. (see page 7)

Methodology Used to Measure the Reported Benefit:

We reviewed the expenditures reported to the Congress for the five undercover operations included in our review that were authorized to churn. For Fiscal Year (FY) 1999, CI reported \$1.44 million in total expenditures for these operations. We calculated total expenditures from the inception of these operations at \$1.46 million, for a difference of \$20,000. For FY 1998, CI reported \$812,000 in total expenditures for these operations. We calculated total expenditures from the inception of these operations at \$931,000, for a difference of \$119,000. The total difference for the two fiscal years is \$139,000.

Type and Value of Outcome Measure:

- Reliability of Information – Actual:
 - 2d----- \$917,795 of expenses (see page 10)
 - 2d----- \$15,400 of understated income and expenses (see page 11)
 - 2d----- \$9,655 of netted expenses (see page 11)

Methodology Used to Measure the Reported Benefit:

We reviewed the financial records for 17 undercover operations and compared the documentation to the expenses claimed on the Claim for Reimbursement for Expenditures on Official Business (Standard Form 1164):

- 2d----- We were unable to attest to whether the financial records fairly presented the revenues and expenses of the operation. In addition to inconsistent accounting practices, supporting documentation was lacking for some of the individual transactions included in the total reported expenses of \$917,975, which

Financial Review of Criminal Investigation's Group I Undercover Operations

prevented us from rendering an opinion on the overall accuracy of the financial records.

- 2d----- Income was not reflected on winning wagers, and expenses were not reflected on losing wagers. Instead, the losing wagers were netted against winning wagers and a net amount was reflected on Standard Form 1164. Therefore, income and expenses for the operation were understated by \$15,400.
- 2d----- When one operation was transferred to another office, \$9,500 of expenses incurred in the recipient office was not recorded. When we totaled the supporting documentation for the expenses and compared it to the amount of expenses claimed on the Standard Form 1164, there was approximately \$9,500 more in expenses than was claimed on the Standard Form 1164. The expenses had been netted against the funding that was transferred to the recipient office, causing the expenses to be understated. In addition, interest was earned in a bank account and bank charges of \$155 were netted against the interest and not recorded, causing expenses to be understated.

Type and Value of Outcome Measure:

- Cost Savings (questioned costs) – Potential: \$715.00 was paid twice (see page 12)

Methodology Used to Measure the Reported Benefit:

The \$715.00 was paid once with the original receipt and again with a photocopy of the receipt.

**Financial Review of Criminal Investigation's
Group I Undercover Operations**

Appendix V

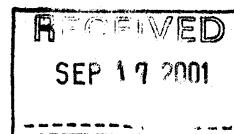
Management's Response to the Draft Report



Criminal Investigation

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SEP 14 2001



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: 
Mark E. Matthews
Chief, Criminal Investigation

SUBJECT: Response To Draft Audit Report - Financial Review of
Criminal Investigation's Group I Undercover Operations
(Audit # 200010031 and ECMS IR No. 0108-4ZNN6AYC)

Thank you for the opportunity to respond to your draft report titled "Financial Review of Criminal Investigation's Group I Undercover Operations." Your draft report summarizes the results of the financial audits of seventeen (17) of Criminal Investigation's (CI) Group I undercover operations closed from March 1997 through August 2000. Undercover operations are critical to conducting significant and complex investigations in support of CI's mission. We take your findings and recommendations very seriously and will use them to improve our procedures and oversight of our undercover operations.

We agree we need some clarification and consistency on the financial matters of our undercover operations. Criminal Investigation already addressed two of the issues you raised in your report. Our internal processes show CI's commitment to reviewing and implementing practices that ensure uniformity of the accounting for our undercover operations. In addition, we revised our request to the field for information needed in the Congressional reports for churning. Churning is the use of income that the undercover operation generates to fund the operation's confidential expenses.

Inconsistent Treatment of Income from Undercover Operations

I will reissue the memorandum dated December 15, 1997 to all field offices outlining the alternative procedures for handling churned funds. We believe this procedure is the most resource efficient approach in handling the churned funds. This alternative process permits the special agent to remit the churned funds, up to the amount of the confidential funds expensed on a fiscal basis, to the IRS Finance Section. Special agents will return any income earned in excess of the amount expensed to the General Fund. In addition, the Area Undercover Program Manager will provide guidance in the proper handling of churned funds for those operations authorized for churning at the pre-operational meeting. These procedures comply with the intent of the churning legislation while reducing taxpayer burden.

Financial Review of Criminal Investigation's Group I Undercover Operations

2

Expenditures of Undercover Operations Were Not Accurately Reported to the Congress

I recognize the importance of providing accurate and reliable financial information about our churning undercover operations to the Congress. Prior to your financial audit, we improved the process to ensure the accuracy of the income and expenses reported. We simplified and clarified the format of the request forwarded to the field for years beginning with FY00. In addition, we expanded the format, beginning with the FY00 request, to include specific dates for capturing income and expenses. These dates include not only the current fiscal year, but also the aggregate of income and expenses for the undercover operation. This format gives the Special Investigative Techniques Analyst the collective information needed to conduct an independent reconciliation of the prior years figures to the current year's information.

Some Improvements Are Needed in the Accounting Practices for Undercover Operations

Our November 1997 nationwide implementation of the Quickbooks software program for all undercover operations should remedy inconsistent accounting practices in our operations. Quickbooks allow all operations, regardless of complexity, elapsed time, or volume of activity to maintain a sufficient set of computerized books and records. Prior to November 1997, we authorized the field to use Quicken or Quickbooks software for the financial aspects of the undercover operations.

In the 2d [REDACTED] undercover operation, you said special agents took funds received from subjects of the operation directly to vendors for the purchase of goods, instead of depositing them into a bank account. This was authorized when the undercover operation was approved and deemed operationally necessary. In undercover operations, operational needs sometimes transcend the generally accepted auditing and accounting standards by which you conducted your audit. You also stated that special agents did not record the transactions in the Quicken software. We approved the Quicken software for use in this operation however, unexpectedly, the undercover became very active and record intensive. Quicken, which does not allow for a complex set of books, became inadequate for the activity of the operation. Consequently, the field office had to continue using Quicken for the continuity of the software record keeping and augment the records with other spreadsheets. Although they did not consistently record transactions in the supporting spreadsheets in gross amounts, they recorded all transactions.

We are reviewing our procedures to account for churning in gambling undercover operations. You said you did not agree with the manner in which our agents accounted for wagers and winnings in the 2d [REDACTED] operation. We are seeking guidance from counsel on this matter. When a final determination is made, we will give the field directions for handling wagering financial activity.

Financial Review of Criminal Investigation's Group I Undercover Operations

3

In the 2d [REDACTED] undercover operation, you mentioned the issue of the commingling of confidential and recoverable funds. This operation served two functions:

1. To assist the field in establishing covert identities
2. To have limited undercover contacts with approved targets

Our procedures allow undercover agents to commingle of funds for operational needs so long as he or she provides an accounting of the funds. The supervisory special agent (SSA), undercover agents and the special agent in charge (SAC) conducted a monthly reconciliation of the funds as required by Internal Revenue Manual (IRM) [9.4.8.16.2 (6)].

In the 2d [REDACTED] undercover operation, you indicated that the operation might have expensed \$715 twice using both an original receipt and a copy of the receipt. This may have caused us to reimburse the undercover agent twice for the same expense. We are reviewing the operation's records to determine whether or not double reimbursement occurred. If necessary, we will take appropriate corrective action.

Our comments on the specific recommendations in this report are as follows:

IDENTITY OF RECOMMENDATION #1

The Chief, CI, should issue guidance that clarifies the accounting practices that should be followed for undercover operations approved for churning to ensure income from an operation is properly used to offset the expenses of that operation.

ASSESSMENT OF CAUSE(S)

The treatment of churning was inconsistent because we provided conflicting guidance concerning the treatment of churned funds to the field.

CORRECTIVE ACTION (S)

We will reissue the memorandum on the alternative treatment of churning that the Chief, CI issued on December 15, 1997. We will provide additional guidance on the treatment of churning in gambling undercover operations.

IMPLEMENTATION DATE

January 1, 2002

RESPONSIBLE OFFICIAL(S)

Chief, Criminal Investigation
Director, Operations Policy and Support
Director, Special Investigative Techniques Section

CORRECTIVE ACTION(S) MONITORING PLAN

The Undercover Program Manager will review the treatment of churning during 90-day operational reviews and each pre-operational meeting, when applicable.

Financial Review of Criminal Investigation's Group I Undercover Operations

4

IDENTITY OF RECOMMENDATION #2

The Chief, CI, should provide guidance to field operations regarding how to calculate the expenditure amounts that are used in the annual reports to the Congress.

ASSESSMENT OF CAUSE(S)

The annual request to the field for financial information on approved churning undercover operations did not provide specific dates applicable to the amounts to be provided.

CORRECTIVE ACTION (S)

The Special Investigative Techniques Section changed the format of the request to the field for FY00 figures regarding churning operations.

IMPLEMENTATION DATE

Completed October 1, 2000

RESPONSIBLE OFFICIAL(S)

Chief, Criminal Investigation
Director, Operations and Policy Support
Director, Special Investigative Techniques Section

CORRECTIVE ACTION(S) MONITORING PLAN

We will continue to monitor churning during the Undercover Program Manager's 90-day operational review.

IDENTITY OF RECOMMENDATION #3

The Chief, CI should ensure that guidance issued to account for funds used in undercover operations promotes accuracy, uniformity, and consistency in accounting for undercover operations.

ASSESSMENT OF CAUSE(S)

We used varieties of financial software in undercover operations for the period covered by this audit. This resulted in inconsistent accounting practices.

CORRECTIVE ACTION (S)

In November 1997, CI mandated that the field use Quickbooks on all undercover operations. Recently, CI retrained all undercover agents and required the use of Quickbooks. Using one software program should resolve accounting inconsistencies.

IMPLEMENTATION DATE

Completed July 1, 2001

RESPONSIBLE OFFICIAL(S)

Chief, Criminal Investigation
Director, Operations and Policy Support
Director, Special Investigative Techniques Section

Financial Review of Criminal Investigation's Group I Undercover Operations

5

CORRECTIVE ACTION(S) MONITORING PLAN

The Undercover Program Manager's 90-day operational review will address any matters not corrected as will the field office's 90-day financial review.

If you have any questions or need additional information, please contact me at (202) 622-3200 or a member of your staff may contact the Director, Special Investigative Techniques Section, James J. Michalak at (202) 622-4140.

Attachment